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BEFORE THE

Federal Communications Commission

WASHINGTON, D.C. 20554

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SEP 30 1993

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of

Implementation of the Cable
Television Consumer Protection
and Competition Act of 1992

Rate Regulation

Third Notice of Proposed Rulemaking

MM Docket No. 92-266

COMMENTS OF THE HEARST CORPORATION

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SUMMARY

The FCC's preferred going forward methodology set forth in the Third Notice has as one of its goals the creation of incentives for the addition of existing and new program services. Under the agency's recommended approach, however, when a channel is added to a non-basic tier the downward benchmark curve is applied to all channels on all regulated tiers. The result, in numerous cases, is that the addition of a channel to the non-basic tier may decrease the rate on the basic tier whose level of service has not changed. In some cases, this could cause the operator to incur a net loss when it adds a channel. In many instances, therefore, widespread a la carte offerings threaten to become the practical alternative if carriage is considered at all.

Hearst submits that only the new channels that a cable operator adds should be subject to the revised benchmark rate. Channels carried on September 1, 1993 should remain at the existing (Line 600) permitted rate. Where the programming cost of the new channel exceeds the reduced benchmark rate, however, the cable operator must recover its programming costs.

In the alternative, the Commission's methodology for compensating cable operators must, at the very least, be applied on a tier specific basis. Tier specific application is necessary to ensure that a loss of revenues will not result from adding quality programming nor will some classes of subscribers face rate alterations without a change in their level of service.

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Comments of The Hearst Corporation

The Hearst Corporation ("Hearst"), by its attorneys, hereby files its comments in response to the Third Further Notice of Proposed Rulemaking ("Third Notice") in this proceeding.¹ Hearst has ownership interests in a variety of existing cable programming services including ESPN, Lifetime, Arts & Entertainment and New England Cable News and is currently involved with two new cable networks, History TV (H-TV) and ESPN 2. Hearst has no financial interests in cable television system operations. Because of the potential disincentives to add new programming after September 1, 1993, Hearst will be directly affected by new rules the Commission adopts regarding the regulation of cable rates when service levels are altered.

¹ Implementation of Rate Regulation Sections of the Cable Television Consumer Protection and Competition Act of 1992, First Order on Reconsideration, Second Report and Order and Third Further Notice of Proposed Rulemaking, MM Dkt. No. 92-266 (Rel. Aug 27, 1993) ("Third Notice").

Hearst is therefore an interested party in this proceeding.

I. Introduction

Hearst and cable programmers generally have been handicapped by the uncertainty surrounding the FCC's regulation of rates for cable programming services that were carried on cable systems as of September 1. The FCC's benchmark rates create a difficult environment for on-going contract renewal negotiations. Indeed, because the FCC's initial benchmark formula does not guarantee adequate returns and because the cost-of-service option remains uncertain and lengthy, many cable operators feel compelled to utilize a la carte offerings as the only remaining approach with any modicum of certainty.

Faced with this difficult environment for cable programmers, Hearst was hopeful that the FCC's approach to establishing rates for channels added subsequent to September 1, 1993 would encourage cable operators to add new high quality cable networks to existing tiers of service. In fact, however, it appears that the FCC's Third Notice does little to allay the concerns of the cable programming industry. This is because, under the FCC's preferred methodology, a cable operator that, after September 1, 1993, adds a channel to its existing regulated service (particularly a relatively low cost channel), may recover less net revenue than a similar system that was already offering the added channel on September 1. Indeed, the system, by adding the channel after September 1, 1993, could actually suffer a net loss of revenue as a result. Consequently, Hearst respectfully urges

the FCC to take a fresh look at its "going forward" approach to ensure a vibrant cable programming industry.

II. Tier Neutrality Affecting New Cable Networks Is Not Viable

The FCC's preferred methodology as described in the Third Notice, appears to provide cable operators with little, if any, additional compensation from adding new programming services. The purpose behind the FCC's recommended approach is to provide incentives for continued programming growth while protecting subscribers from unreasonable rates (Third Notice, ¶136). While this is a desirable goal, the FCC's methodology apparently fails to ensure that a cable operator can recover its programming cost for any new cable network added on a regulated tier. In short, the FCC's proposed methodology suffers in its complexity and, most importantly, in its failure to provide economic incentives to add cable programming in the many instances when an operator has more than one regulated tier.

Under the FCC's proposal the new rate allowed in adding a channel would be the existing (Line 600) permitted rate per channel as of September 1, 1993, adjusted downward to reflect the proportionate decrease found in the FCC's benchmark tables. This new per channel rate is also adjusted based on the impact of the programming cost of the new cable network on the system's prior average programming cost.²

² Under this computation, the lower the current per channel average programming cost the higher the net profit to the cable operator from adding a channel. If a cable operator has a small marginal profit based on high current program costs the FCC's formula simply maintains that level going forward.

Consider one representative situation.³ A cable system with 10,000 subscribers has 35 channels, of which 15 channels (costing the operator \$.30) are on the basic tier and 20 channels (costing the operator \$3.20) are on the second tier. Furthermore, assume that all 10,000 subscribers take the basic tier and 5,000 subscribers take the second tier. The system's average programming cost computed on a weighted "per subscriber-channel" basis is \$.076⁴ and revenues from these two regulated service tiers would equal \$151,000 based on an initial maximum permitted rate of .604 per channel. Under the FCC's proposal, as we understand it, this cable operator could lose money if it adds an additional satellite channel to the non-basic tier. Specifically, if the system adds an additional satellite channel costing .50 cents per subscriber, its allowed maximum permitted rate would become \$0.601. Although logic would suggest that 36 channels at \$0.601 per channel should generate more revenue than the prior 35 channels at \$0.604 per channel, this is not the case. The problem is that not all subscribers take all regulated channels. In fact, after deducting \$2,500 in new programming costs, net revenues will fall to \$150,800. Thus, adding a channel decreases net revenues by \$200 per month.

Why does this happen? First, the FCC's approach preserves

³ See Appendix A.

⁴ Although the Third Notice does not specify how an average programming cost is to be computed, it is our understanding that such computation is to be made on a weighted "per subscriber-channel" basis. This is the same methodology adopted by the Commission for use in completing Form 393.

the current requirement that a cable operator must reduce his permissible rate on the basis of the benchmark table "slope." Secondly, the FCC's "going forward" methodology apparently preserves the requirement of tier neutrality - applying the new lower per channel benchmark rate to all regulated channels and not just to the added channel (or to the specific tier to which the service is added). Thus, if the non-basic tier to which the new channel is added is taken by only a percentage of all basic subscribers, the lost revenue from a decrease in the basic tier rate will not be made up by the marginal increase in the non-basic tier price. Whether or not revenues (not rates) increase or decrease and by how much will depend in each case on (1) the number of channels on the tier obtaining the added channel relative to the total number of channels and (2) the number of subscribers on that tier relative to the total number of subscribers. Even if there is no net revenue decrease in a particular case, the net gain will frequently be so small as to not cover the capital cost associated with the utilization of the additional system channel capacity to add the new service. The FCC's new proposal in the Third Notice not only perpetuates these problems, but actually exacerbates them for cable programmers because of the substantial complexities involved in computing a new rate under the FCC's proposal.

Additionally, the FCC's proposal will create substantial public relations problems for cable operators. Retaining the concept of tier neutrality after September 1, 1993 will force a

reduction (or increase, if the cost of the new service is relatively high) in the rate on the basic tier that has had no change in level of service when programming is added (or deleted) on the non-basic tier. Whether basic service rates (not revenues) go up or down following the addition of a new cable network to the non-basic tier generally is a function of the programming cost for the new service. Regardless of the mathematical mysteries, however, the bottom line is that adding a channel to the non-basic tier will cause a basic-only subscriber to get a rate increase or decrease. Cable programmers are unlikely to convince cable operators to add new program services if doing so will likely create confusion over why rates have changed on otherwise unaffected tiers and, thereby, cause undue criticism of the operator by subscribers and local officials.⁵

The economic and practical problems and disincentives caused by applying the going forward methodology on a tier neutral basis are not isolated examples. Most cable operators today offer multiple tiers of regulated service - basic service and at least one other tier of service above the basic tier. More often than not, in this regulatory climate Hearst expects its cable network programming to be added to a non-basic tier. Under the FCC's proposal, the new lower per channel benchmark rate that often

⁵ Indeed, in those limited instances where the programming cost of the new channel added to non-basic causes the maximum permitted rate to increase, the FCC's proposal compelling tier neutrality may result in the ultimate impolitic result - the basic tier rate will rise for basic only subscribers who receive no additional channels.

results when a channel is added to non-basic applies to all channels on all regulated tiers with the undesirable results described above. And these disincentives to add a new cable network to a regulated tier (other than the basic tier to which all subscribers must subscribe) exist under the FCC's methodology even if Hearst attempts to encourage such addition by pricing its quality services initially at a very low cost per subscriber. As shown below, the distinct possibility remains that overall regulated revenues will decrease due to the addition of the channel despite the FCC's intent to permit recovery of added programming costs.

Using the same example given above, assume that the additional satellite channel is a lower cost service, \$.10 per subscriber instead of \$.50 as assumed earlier. Applying the Commission's formula, the maximum permitted rate per channel falls from \$0.604 to \$0.593. Yet, even though gross revenue increases from \$151,000 to \$151,250, program costs increase by \$500 (5,000 subscribers x \$.10), resulting in a net loss of \$250.⁶

These examples demonstrate that cable operators may have little incentive in many cases to add programming to existing regulated tiers under the FCC's tier neutral approach. But at least in those cases the operator is able to estimate the additional revenue it will receive from the rate increase applied to existing subscribers to the tier to which the service is added

⁶ See Appendix B.

and compare that revenue with the loss from the reduction of other tier rates.

Where cable operators would like to initiate a new tier of cable services, however, tier neutrality creates even greater problems. For example, consider a cable operator currently offering 35 channels who is planning a new five channel tier of service above the basic tier containing, for example, H-TV, ESPN 2, New England Cable News and two other program services at approximately the same average cost per channel as the current channels. The operator knows for certain that under the FCC's proposal he will likely have to reduce the rate for the existing basic since the per channel maximum permitted rate will have gone down due to the benchmark table "slope". However, the operator does not, and cannot, know what number of subscribers will take the new tier from which additional compensation would be received. Thus, starting a new tier of service under the FCC's methodology is even riskier, and thus less likely to occur, than the addition of one or more additional cable channels to an existing tier.

Another concern of cable programmers, which should not be overlooked, is that the FCC's going forward approach will have the effect of promoting a la carte carriage of program services whose businesses have been and continue to be based on broad distribution through carriage on a cable tier. If widespread a la carte offerings become the sole remaining practical alternative for cable operators to add channels, it will be

ruinous for programmers not only because of reduction in fee revenue, but more importantly, because the advertising revenue for these services will decline in geometric proportion to any decrease in distribution and viewership.

The financial structure of cable programming services is based upon the premise that each one fits into a package offering to consumers. Consumers enjoy a wide range of programming options in subscribing to a tier of cable service and advertisers purchase time based upon a network's wide distribution. If adding programming to regulated tiers is eliminated in favor of a la carte, consumers will in a short time not even have the option of viewing many of their favorite channels because advertisers will no longer support them.⁷

Finally, Hearst is concerned about the complexities and confusion that are inherent in the FCC's approach. Complexity associated with FCC rate regulation has been a major impediment to cable programmers' efforts to demonstrate the benefit to cable systems of adding quality programming. Representatives of New England Cable News, H-TV and other new cable services have all experienced significant difficulty in convincing cable operators to add channels under the present uncertain regulatory environment. If cable operators cannot easily compute the level

⁷ See Kagan, Cable TV Programming (March 22, 1993). Hearst respectfully suggests that the FCC should make no decision with respect to any going forward methodology without closely reviewing the detailed study done by Paul Kagan Associates, Inc. The study indicates that even a ten percent reduction of a cable network's audience base would lead to a disproportionately larger percentage decrease in operating cash flow.

of increased compensation from adding new cable networks, they will be very reluctant to make such additions.⁸

In particular, the FCC's current approach involves too many steps, too many complex computations, and too much uncertainty. In the face of these difficulties cable operators will not risk the addition of new programming costs. For example, if adding or deleting a program service on a non-basic tier causes the rate for the basic tier to increase or decrease, local regulatory authorities would appear to have to deal with these rate changes. While local authorities are more likely to react quickly to force decreases where tier neutrality requires a reduction of the basic rate, we would anticipate such authorities would move less expeditiously to allow operators to increase basic rates where the benchmark rates would permit such increases. Thus, the prospect of local regulatory delay will discourage cable operators from adding service. If there are to be real incentives for new cable networks to be added, cable programmers must be able to demonstrate, and cable operators must be able to easily perceive, the benefit without the need to employ a cadre of economists and attorneys.

⁸ The pessimistic prospects facing the great majority of new cable programmers should not be confused with those few new cable services which have to a degree overcome this obstacle by virtue of linkage with retransmission consent agreements to achieve substantial distribution commitments or the announcement of certain programming services whose economics make them less reliant on advertising revenue.

III. The Hearst Proposal

Hearst proposes certain modifications to the FCC's proposal to provide reasonable incentives for cable operators to add new, quality programming to their systems.

First, the FCC should eliminate the principle of tier neutrality. When a new channel is added, the rate for the newly added channel should be based only on the prior permitted rate, adjusted to reflect the "slope" in the benchmark table. The price for existing channels should remain unchanged at the former maximum permitted rate. In those instances where the programming cost of the new channel exceeds the new permissible rate, the cable operator should be allowed to recover that cost, plus a reasonable profit. This latter point is crucial to encourage more expensive cable networks to be added to regulated tiers rather than only a la carte or not at all. This is particularly so for systems with large numbers of regulated channels that face a low benchmark rate for any new channel added.

Second, an alternative to the preferred Hearst approach would be to more closely follow the FCC's methodology but focus only on the tier to which the new channel is added after September 1. Therefore, if ESPN 2 is added to the non-basic tier after September 1, the new lower permitted rate would apply only to the channels on that tier. Channels on all other regulated tiers, including basic, that have no change in the level of service would continue to be governed by the benchmark rate applicable at the pre-September level.

Thirdly, if the programming cost of a newly added channel and existing average per channel programming costs are to remain a factor in the methodology, this computation should be based only on the average programming cost on the regulated tier to which the channel has been added or deleted, not the average cost of all services on all regulated tiers.

Finally, as shown above, the regulatory uncertainty and complexity of the FCC's approach discourages the addition of new cable programming. Cable operators who add new programming services and are paying the programmer accordingly must be able to recover their increased costs from subscribers. If local regulatory delay can raise questions regarding the recovery of added programming costs, new cable networks will not be able to convince cable operators to add such programming. Therefore, the FCC must ensure that any basic tier rate increases permitted by its "going forward" proposal can be implemented immediately after the 30 day notice to subscribers required by the Cable Act without local regulatory impediments.⁹

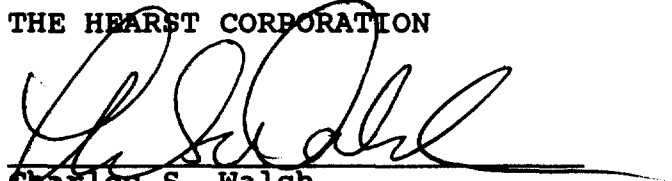
⁹ A further critical regulatory issue for program networks is the timing of pass-throughs of contractually mandated programmer cost increases. The FCC must prevent local regulatory authorities from preventing or delaying these justified cost pass-throughs. Similarly, regulatory authorities should not be allowed unfettered access to otherwise confidential and highly proprietary program contracts. Cable operators, who will make cost computations of permissible rates based on overall program cost increases, should be allowed to attest to these overall cost changes without undue regulatory intrusion into individual and quite sensitive program arrangements.

IV. Conclusion.

For the foregoing reasons, Hearst respectfully urges the adoption of rules consistent with its proposal to provide the needed incentives, clarity and certainty for the development and carriage of new, high quality cable programming.

Respectfully submitted,

THE HEARST CORPORATION

A large, stylized handwritten signature in black ink, appearing to read 'C. S. Walsh', is written over the typed name and firm name.

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APPENDIX A

I. Programming Cost Adjustment

A Current Average Per Subscriber-Channel Programming Cost

$$\frac{(10,000 \text{ subs.} \times .30) + (5,000 \text{ subs.} \times \$3.20)}{(10,000 \text{ subs.} \times 15 \text{ ch.}) + (5,000 \text{ subs.} \times 20 \text{ ch.})} = \frac{19,000}{250,000} = \underline{.076}$$

B. Adjusted Average Per Subscriber-Channel Programming Cost (After Adding Channel @ .50/subscriber)

$$\frac{(10,000 \text{ subs.} \times .30) + (5,000 \text{ subs.} \times \$3.70)}{(10,000 \text{ subs.} \times 15 \text{ ch.}) + (5,000 \text{ subs.} \times 21 \text{ ch.})} = \frac{21,500}{255,000} = \underline{.084}$$

II. Going Forward Calculation

.604	(initial Line 600 per channel rate)
- .076	(initial per subscriber channel programming cost)
.528	
- .011	(2% benchmark table "slope" adjustment)
.517	
+ .084	(new per subscriber channel programming cost)
.601	NEW PERMITTED PER CHANNEL RATE

III. Revenue Comparison

A. Current Revenues

Basic Tier: .604 x 15 ch. = \$9.06 x 10,000 subs.	=	90,600
Expanded Tier: .604 x 20 ch. = \$12.08 x 5,000 subs.	=	+ <u>60,400</u> = \$151,000

B. Going Forward Revenues

Basic Tier: .601 x 15 ch. = \$9.02 x 10,000 subs.	=	90,200
Expanded Tier: .601 x 21 ch. = \$12.62 x 5,000 subs.	=	+ <u>63,100</u>
Net Revenues After Adding New Channel		\$153,300
Programming Cost: .50 x 5,000 subs.	=	- <u>2,500</u> = \$150,800

NET LOSS AFTER ADDING NEW CHANNEL

(200)

APPENDIX B

I. Programming Cost Adjustment

A Current Average Per Subscriber-Channel Programming Cost

$$\frac{(10,000 \text{ subs.} \times .30) + (5,000 \text{ subs.} \times \$3.20)}{(10,000 \text{ subs.} \times 15 \text{ ch.}) + (5,000 \text{ subs.} \times 20 \text{ ch.})} = \frac{19,000}{250,000} = \underline{.076}$$

B. Adjusted Average Per Subscriber-Channel Programming Cost (After Adding Channel @ .10/subscriber)

$$\frac{(10,000 \text{ subs.} \times .30) + (5,000 \text{ subs.} \times \$3.70)}{(10,000 \text{ subs.} \times 15 \text{ ch.}) + (5,000 \text{ subs.} \times 21 \text{ ch.})} = \frac{19,500}{255,000} = \underline{.076}$$

II. Going Forward Calculation

.604	(initial Line 600 per channel rate)
<u>-.076</u>	(initial per subscriber channel programming cost)
.528	
<u>-.011</u>	(2% benchmark table "slope" adjustment)
.517	
<u>+.076</u>	(new per subscriber channel programming cost)
.593	NEW PERMITTED PER CHANNEL RATE

III. Revenue Comparison

A. Current Revenues

Basic Tier: .604 x 15 ch. = \$9.06 x 10,000 subs.	=	90,600
Expanded Tier: .604 x 20 ch. = \$12.08 x 5,000 subs.	=	+ <u>60,400</u> = \$151,000

B. Going Forward Revenues

Basic Tier: .593 x 15 ch. = \$8.90 x 10,000 subs.	=	89,000
Expanded Tier: .593 x 21 ch. = \$12.45 x 5,000 subs.	=	+ <u>62,250</u>
	=	\$151,250
Programming Costs: .10 x 5,000 subs.	=	- <u>500</u> = \$150,750

NET LOSS AFTER ADDING NEW CHANNEL (250)